



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

B =
P =

Dear :

We have considered your letter of November 18, 2011, in which you request rulings on the federal tax consequences of the transactions described below.

Facts

You are a non-profit, non-stock corporation that is exempt from federal income taxation under I.R.C. § 501(a) as an organization described in § 501(c)(3). You are considered a private foundation within the meaning of § 509(a) as well as an operating foundation within the meaning of § 4942(j)(3).

You were formed by the artist B to further his philanthropic and educational initiatives. As stated in your articles of incorporation, your purposes include the following:

- 1) to directly or indirectly support charitable, religious, scientific, artistic, literary, educational, or cultural purposes; and, more specifically...

- 5) to cultivate, promote, encourage, and support the production and exhibition of art, to enlarge the interest and importance of the quality of art, to establish and maintain a permanent collection of works of art, and to establish a center for the advancement of such purposes.

Consistent with these purposes, your stated mission is "to further B's philanthropic initiatives and to preserve and advance the global understanding of the legacy of his life and artwork." Within that mission, you focus on (a) philanthropic initiatives that were important to B during his

lifetime (e.g., fostering artistic collaborations, integrating art into education, and using art to change awareness and increase funding for the environment) and (b) scholarly programs related to the life and legacy of B.

P

B formed P, a corporation, to house his artistic enterprise. B, his studio assistants, and other art production staff were employees of P. P acquired and stored the materials used by B in the creation of his artwork, handled the creation, fabrication, shipment, storage, and insurance of this work, and managed its sale, reproduction, and licensing. B transferred the stock of P to a revocable trust, of which B was the sole beneficiary during his lifetime (the "Revocable Trust").

B actively oversaw the operations of P until his death, by which time P had accumulated a large collection of original B artwork (the "B Collection") as well as nearly all B copyrights since a certain year (the "P-B Copyrights"). Pursuant to the instrument governing the Revocable Trust, which remains the sole shareholder of P, the stock of P is to be transferred to you as sole remainder beneficiary. Upon the transfer of the stock of P, you will hold all of the issued and outstanding shares of P. You state that you wish and intend to hold the stock of P indefinitely.

With the death of B, the focus of activities within P switched from the production, sale, and licensing of artwork to curatorial activities and the management of the B artistic legacy.

Proposed Use of the B Collection and the P-B Copyrights

You intend to use the B Collection and the P-B Copyrights to increase public exposure and understanding of the broad scope of B's work, advance B scholarship, and encourage artists' involvement in civic issues by showing that art can change the world. Toward that end, and using the assets that are held by P, you plan to:

- 1) respond to requests from museums, scholars, publishers, and others seeking knowledge and understanding of B's life and artistic legacy;
- 2) develop a comprehensive scholarly resource – a *catalogue raisonné* – that documents all work produced by B and illustrates the evolution of his work over his lifetime;
- 3) create a robust digital repository of images of B's work so as to support scholarship on a global basis; and
- 4) prepare, record, edit, and archive a series of interviews with artists and scholars that will constitute an oral history of B's life and artistic legacy.

In addition, using the B Collection held by P, you plan to create a "lending bank" that will place artwork from the B Collection in museums and other charitable organizations focused on art promotion and scholarship throughout the world. The "lending bank" program will complement your grantmaking support of curatorial programs at university museums to ensure creative and educational use and interpretation of the artwork from the B Collection by graduate and undergraduate students.

Your charitable and educational priorities will guide decisions about loans, gifts, and sales from

the B Collection to museums, schools, art institutes, and other charitable entities. Loans of artwork from the B Collection may be authorized if the prospective borrower's use of the artwork will be consistent with and in furtherance of your charitable and educational objectives. Your standards for art preservation and conservation, security, and insurance will govern all such lending decisions, and you will, as appropriate, specify those works that may not be lent due to their condition or significance.

Gifts or sales by P of artwork from the B Collection may be authorized if the prospective donee or purchaser is a museum or other § 501(c)(3) organization, and the arrangement will further your charitable and educational objectives. In addition, sales may be authorized if you determine (1) that works comparable to the item being sold will remain in the B Collection or other publicly accessible collection, (2) that the sale can be made in the context of an art gallery exhibition that will advance public and scholarly knowledge and understanding of one or more aspects of B's work, or (3) that the sale will enable you to pursue critical philanthropic or scholarly activities.

Similarly, your charitable and educational priorities will guide decisions about licensing and reproduction, the aesthetic and quality standards for all licensing and reproductions involving B copyrights (including the P-B Copyrights), and the standards and practices for policing and controlling the B copyrights.

You plan to make information about the B Collection available to those seeking to authenticate works believed to have been created by B. The collection of information about such works will advance your goals for B scholarship, particularly the development of an authoritative *catalogue raisonné*.

You will undertake the ongoing conservation and management of the B Collection. The management function will include cataloguing and tracking the whereabouts and condition of the artwork in the B Collection, obtaining appropriate insurance coverage for the B Collection, and overseeing and managing security, insurance claims, climate control, and operations generally at the art exhibition and storage facilities where you plan to require that the B Collection be stored.

Finally, all activities involving P or its assets will be conducted so as to avoid any transactions that would constitute an act of self-dealing within the meaning of § 4941(d). You will adhere to policies and procedures to identify and address potential conflicts of interest.

Collection Agreement

Upon receipt of the stock of P, you, as its sole shareholder, plan to enter into the art collection management agreement (the "Collection Agreement") with P, described below. The Collection Agreement will appoint you as its sole and exclusive agent for the purpose of managing the B Collection. Management activities will include the conservation, cataloguing, and documentation of the B Collection; responsibility for making decisions concerning the use, sale, exchange, loan, donation, storage, shipment, and insurance of the B Collection; responsibility for making decisions concerning the licensing, policing, and control of the P-B Copyrights; and

the negotiation, implementation, and administration of all agreements pertaining to the B Collection and the P-B Copyrights.

You will be entitled to receive reasonable compensation for your services to P. The compensation will be set before the commencement of each contract year and paid in monthly installments. The Collection Agreement will automatically renew from year to year.

To facilitate your ability to catalogue, document, conserve, lend, and otherwise manage the B Collection, the Collection Agreement will require that tangible works of art in the B Collection be housed in one or more secure and climate-controlled art storage or exhibition facilities under your control. Works of art in electronic form (i.e., digital or video works) will be stored on servers designed by and under your control.

P will cease to have its own employees. You will employ a staff, which will include a curator, a collections manager, an archivist, a registrar, an executive director, chief financial officer, and other staff necessary for the management of your activities, including the activities related to your ownership of P.

Rulings Requested

You have requested the following rulings:

1. The stock of P will not be excess business holdings under § 4943, and will not be taken into account in determining your minimum investment return under § 4942(e) because P will be a functionally related business under § 4942(j)(4).
2. Compensation paid to you by P pursuant to the Collection Agreement will not be unrelated business taxable income under § 512.

Law

I.R.C. § 4943(a) imposes a tax on the excess business holdings of any private foundation in a business enterprise.

I.R.C. § 4943(c)(1) provides that the term "excess business holdings" means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundations would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

I.R.C. § 4943(c)(2) provides, generally, that the permitted holdings of any private foundation in an incorporated business enterprise are (i) 20 percent of the voting stock, reduced by (ii) the percentage of voting stock owned by all disqualified persons.

I.R.C. § 4943(d)(3)(A) provides that the term "business enterprise" does not include a functionally related business (as defined in § 4942(j)(4)).

I.R.C. § 4942(a) imposes a tax on the undistributed income of a private foundation for any taxable year that has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year (if such first day falls within the taxable period).

I.R.C. § 4942(c) provides that the term "undistributed income" means, the amount by which—

- 1) the distributable amount for such taxable year exceeds
- 2) the qualifying distributions made before such time out of such distributable amount.

I.R.C. § 4942(d) provides that the term "distributable amount" means, with respect to any foundation for any taxable year, an amount equal to—

- 1) the sum of the minimum investment return plus the amounts described in subsection (f)(2)(C), reduced by
- 2) the sum of the taxes imposed on such private foundation for the taxable year under subtitle A and § 4940.

I.R.C. § 4942(e)(1) provides, generally, that the minimum investment return for any private foundation for any taxable year is 5 percent of the excess of—

- A. the aggregate fair market value of all assets of the foundation other than those which are used (or held for use) directly in carrying out the foundation's exempt purpose, over
- B. the acquisition indebtedness with respect to such assets.

Treas. Reg. § 53.4942(a)-2(c)(3)(ii)(d) provides that assets which are "used (or held for use) directly in carrying out a foundation's exempt purpose," for the purposes of calculating the minimum investment return, includes any interest in a functionally related business.

I.R.C. § 4942(j)(4) provides that the term "functionally related business" means—

- A. a trade or business which is not an unrelated trade or business (as defined in § 513), or
- B. an activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exempt purposes of the organization.

Treas. Reg. § 53.4942(a)-2(c)(3)(iii)(b) illustrates the provisions with respect to functionally related business by the following examples:

Example (1). X, a private foundation, maintains a community of historic value which is open to the general public. For the convenience of the public, X, through a wholly owned, separately incorporated, taxable entity, maintains a restaurant and hotel in such community. Such facilities are within the larger aggregate of activities which makes available for public enjoyment the various buildings of historic interest and which is related to X's exempt purpose. Thus, the operation of the restaurant and hotel under such circumstances constitutes a functionally related business.

Example (2). Y, a private foundation, as part of its medical research program under section 501(c)(3), publishes a medical journal in carrying out its exempt purpose. Space in the journal is sold for commercial advertising. Notwithstanding the fact that the

advertising activity may be subject to the tax imposed by section 511, such activity is within a larger complex of endeavors which makes available to the scientific community and the general public developments with respect to medical research and is therefore a functionally related business.

The General Explanation of the Tax Reform Act of 1969, prepared by the staff of the Joint Committee on Internal Revenue Taxation (December 3, 1970) includes the following explanation to the exception:

An exception to the limitation on the holding of business interests is provided in the case of a business which is related under the provisions dealing with taxes on unrelated business income. Another exception is provided, even where the business, although unrelated to the direct activities of the foundation, "is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exempt purposes of the organization."

These exceptions are intended to make clear that certain types of business activities may continue to be held by the foundation notwithstanding the general rule. Many museums maintain cafeterias and snack bars for the convenience of the public visiting the museums. Although advertising in a foundation's journal may be an unrelated trade or business it comes under the second of these exceptions if the foundation's journal is related to the foundation's exempt purposes. Such business activities do not have to be disposed of under these provisions.

I.R.C. § 511(a) imposes a tax on the unrelated business taxable income of organizations described in § 501(c).

I.R.C. § 512(a)(1) provides that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in § 513) regularly carried on by it, less allowable deductions and certain modifications.

I.R.C. § 513(a) provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by § 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the charitable, educational, or other purpose or function constituting the basis for its exemption under § 501.

I.R.C. § 513(c) provides that, for purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Treas. Reg. § 1.513-1(d)(1) provides that gross income derives from "unrelated trade or business," within the meaning of § 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to

the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question – the activities, that is, of producing or distributing the goods or performing the services involved – and the accomplishment of the organization's exempt purposes.

Treas. Reg. § 1.513-1(d)(2) provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of § 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Treas. Reg. § 1.513-1(d)(4)(i) provides that gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business.

Analysis

Ruling 1

The analysis of the first requested ruling involves three issues.

Whether P is a functionally related business within the meaning of § 4942(j)(4).

Under § 4943(d)(3)(A) the taxes on excess business holdings under § 4943 do not apply with respect to holdings in a functionally related business. Under § 4942(j)(4)(B), a functionally related business includes an activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related to the exempt purposes of the organization. See also § 53.4942(a)-2(c)(3)(iii).

One of your exempt purposes is to cultivate, promote, encourage, and support the production and exhibition of art, to enlarge the interest and importance of the quality of art, and to establish and maintain a permanent collection of works of art, particularly the art of B. As described in your mission statement, you fulfill that purpose by preserving and advancing the global understanding of the legacy of the life and artwork of B. Your policies and staff are devoted to the achievement of that mission. In turn, P's sole corporate purpose will be to promote the work of B. As the holder of the B Collection and the P-B Copyrights, P will be an essential ingredient for the accomplishment of your exempt charitable and educational purposes. The Collection Agreement will ensure that the works of art and copyrights held by P will be fully integrated into your larger aggregate of exempt purpose activities, by ensuring that those assets will be fully available to support the charitable and educational programs that preserve B's artwork and

advance the global understanding of the legacy of his life and artwork. Furthermore, through your ownership of P, you will ensure that P's activities are conducted in ways that advance the global understanding of the legacy of B's life and artwork.

Additionally, conducting the activities described above through a for-profit subsidiary will not prevent P from qualifying as a functionally related business. Section 53.4942(a)-2(c)(3)(iii)(b), Example 1 specifically contemplates the operation of a business functionally related to the accomplishment of a private operating foundation's exempt purpose through a separately incorporated taxable entity.

Consequently, since acquisition of the stock of P will cause the administration of its assets to be in accordance with your policies and the activities of P will be carried on within the scope of preserving, promoting, and furthering global understanding of the legacy of B's life and artwork, P will be a functionally related business within the meaning of § 4942(j)(4).

Whether the stock of P would constitute excess business holding under § 4943.

You will receive all of the stock of P as the remainder beneficiary of B's revocable trust. For purposes of § 4943, the term "excess business holdings" refers to the holdings of a private foundation in a business enterprise. Thus, your holdings in P will be subject to § 4943 only if P is deemed a "business enterprise." Section 4943(d)(3)(A) provides that the term "business enterprise" does not include a functionally related business as defined in § 4942(j)(4). As explained above, P should be treated as a functionally related business. Therefore, P is not a business enterprise under § 4943(d)(3)(A), and your holdings of all the stock of P would not constitute excess business holdings under § 4943(c).

Whether holdings in P would be taken into account in determining your minimum investment return under § 4942(e).

For purposes of § 4942(e), the term "minimum investment return" takes into account the aggregate fair market value of all assets of a foundation other than those which are used (or held for use) directly in carrying out the foundation's exempt purpose. Section 53.4942(a)-2(c)(3)(ii)(d) explicitly excludes any interest in a functionally related business from the calculation of the minimum investment return. Since P will be considered a functionally related business, the value of any interest that you have in P would be excluded from the calculation of your minimum investment return under § 4942(e).

Ruling 2

Whether the compensation that you receive from P under the Collection Agreement would constitute unrelated business taxable income within the meaning of § 512(a)(1).

Under the Collection Agreement, P will compensate you for your management of the B Collection, which management will include the conservation, cataloguing, and documentation of the B Collection, as well as responsibility for making all final decisions concerning the use, sale, exchange, loan, donation, storage, shipment, and insurance of the B Collection, and

responsibility for making decisions concerning the licensing, policing, and control of the P-B Copyrights. Section 512(a)(1) defines "unrelated business taxable income" as gross income derived from an unrelated trade or business (as defined in § 513(a)) that is regularly carried on. Since the management fee would constitute income from a trade or business regularly carried on, it would be includible in your unrelated business taxable income under § 512(a)(1) unless the conduct of the trade or business that produces the income – here, the management of the B Collection – is substantially related to your exempt purposes within the meaning of § 1.513-1(d)(1). Under § 1.513-1(d)(2), a trade or business is substantially related to exempt purposes only if it contributes importantly to such purposes

The conservation, cataloguing, and documentation of the B Collection, your control of the use, lending, storage, maintenance, and sale of the B Collection, and your control of the reproduction and licensing of the P-B Copyrights contribute importantly to the preservation and promotion of the understanding of B's artistic legacy – a central aspect of your charitable and educational mission. Therefore, the activities for which you will be compensated under the Collection Agreement are substantially related to your exempt purposes within the meaning of § 1.513-1(d) and, thus, do not constitute an unrelated trade or business within the meaning of § 513(a). Consequently, the compensation that you receive from P under the Collection Agreement would not constitute unrelated business taxable income within the meaning of § 512(a)(1).

Conclusion

In light of the foregoing, we rule as follows:

1. Upon your acquisition of all of the issued and outstanding stock of P, the implementation of the plans described in "*Proposed Use of the B Collection and the P-B Copyrights*" and the consummation of the Collection Agreement, P will be considered a functionally related business. Accordingly, your ownership of all of the stock of P would not constitute excess business holdings under § 4943, and the value of your interest in the stock of P would not be taken into account in determining your minimum investment return under § 4942(e).
2. The compensation payable to you under the Collection Agreement with P will not be considered unrelated business taxable income within the meaning of § 512(a)(1).

This ruling will be made available for public inspection under § 6110 after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented, without consideration of alternative plans of proposed transactions, without consideration of hypothetical situations, and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the I.R.C. or Treas. Reg. to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Peter A. Holiat
Acting Manager, Exempt Organizations
Technical Group 1

Enclosure
Notice 437